GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Table of Contents

The Best of Times

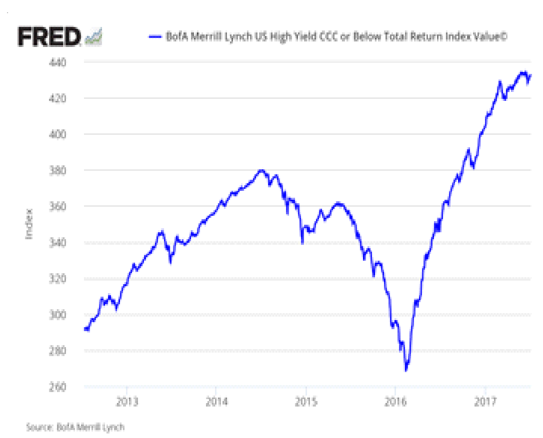
To borrow from Charles Dickens, "it was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness... "Dickens was writing about the time just prior to the French Revolution but I suspect we can apply his words to the present. We are in a time of unparalleled opulence but with little upward mobility, a time of extraordinary scientific breakthroughs but political/economic insanity.

The stock market keeps going up thanks to manipulation sponsored by global central banks. The S&P500 is up 8% year to date even as the global economy shows signs of future problems. Celebrity hedge fund managers are decrying these unnatural returns in the market but I say sit back and enjoy with an eye to the future. Don't pick a fight you can't win but also understand the limitations of central bank policies because there will come a time when they can no longer keep the stock market advancing.

Markets

The capital markets are no longer a functioning clearinghouse for buyers and sellers because they don't set prices based on economic fundamentals. Instead, they're an experiment by central bankers, one that is increasingly looking like a failed experiment. By raising the value of assets, the idea was that banks would lend to fund new investments because the collateral set aside to ensure the performance of the loan was rising. Instead, companies actually reduced investments in order to free up money to invest in the capital markets because they had become essentially risk free.

The chart below shows returns in the junk bond space. Surprisingly, they've been good. It's surprising because junk bonds typically perform poorly in weak economic climates like the one we have in the US. But there is nothing typical about the current period of central bank intervention.



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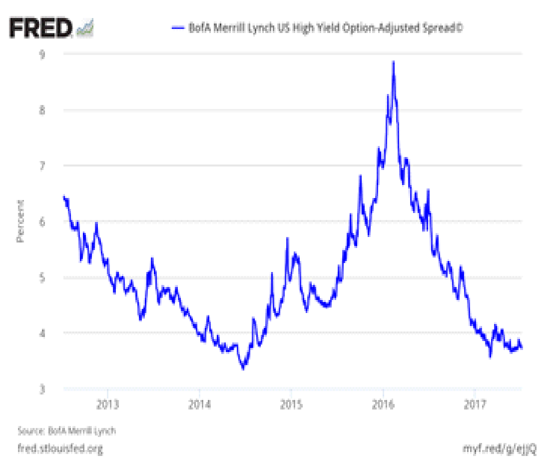
To generalize, this has left us with many companies that have too much debt and too few assets. I've written about this extensively over the years but without a true market, the stocks of many of these companies trade as if they are viable long term entities. We prefer to avoid the stocks and bonds of these companies.

Instead, we prefer to own companies with real assets and products that will remain in demand regardless of the economic backdrop. This next chart shows the difference in yield between junk bonds and US Treasury bonds of similar maturity.



As you can see, the spreads (yield difference) between good (Treasury) bonds and bad (High Yield or Junk) bonds is in the neighborhood of historical lows. This is telling us that investors are willing to accept much higher risk for a paltry near term increase in return. History has never been kind to such trade-offs.

When central banks ultimately lose control of the markets, I believe a significant amount of low quality debt will become worthless. Given that much of this debt resides in wealth management products, the impact on the older generations in America will likely be profound.

Economy

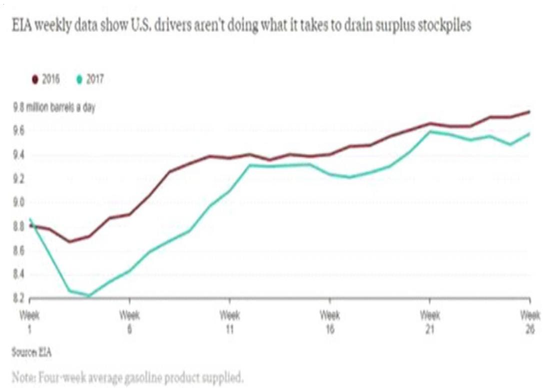
I've often categorized the US domestic economy as having been weak since 2007 and that assertion is at odds with the views of most economists. The difference lies with what I categorize as economic activity.

While it's impossible to completely separate out the government's impact on the US economy, by using some simple metrics such as GDP minus the increase in federal government debt each year, we get a sense of how the so-called growth is achieved. I'll spare you the gory details but we determined that *excess* growth in federal government debt added an average of 4.4% to gross domestic product (GDP) growth each year since the financial crisis in 2008. The remarkable point is that 4.4% is greater than the average increase in economic growth during this period which suggests that all of our economic growth has come from the increase in federal government debt.

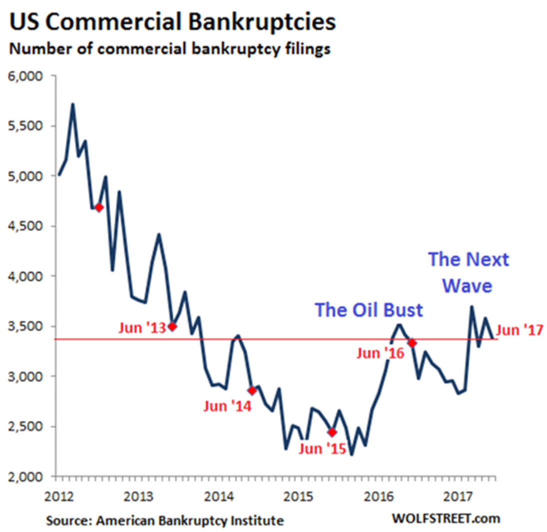
I've likened such behavior in the past to your neighbor running up his credit card to buy a new car and new furniture, even as his paycheck gets smaller. It makes him look like he's thriving but in truth, he's digging a financial hole that he'll be hard pressed to exit. In short, it's an unsustainable trend.

But for the moment, it is our reality. Federal government debt will continue to rise in the near term and that money will be used to keep the economy stable, even if it's not really growing.

The chart below shows gasoline usage in the US. The light blue line is telling us that US drivers are using less gasoline and that suggests that the economy is weakening – not by a lot but weakening on the margin.



The next chart shows that commercial bankruptcies are picking up once again. It's at a manageable level but it tells us that our economy is slowly weakening.



This weakness is at odds with a stock market that is continuing to rise but it illustrates just how important an elevated stock market is to economic policymakers. The continuing rise in the stock market adds legitimacy to the flawed perceptions of economic strength which strongly implies that the government will do its utmost to keep the stock market elevated.

Interest Rates

For the past 18 months, we have been steadfast in our belief that interest rates are headed lower and nothing the Federal Reserve has said or done has shaken this belief. While it is true that the Fed has raised rates a couple of times over this span, it actually increases the likelihood that the bonds that we've been purchasing for clients provide strong returns.

The Fed is raising interest rates into an already weakening economic environment. This suggests that their efforts will weaken the economy further which should ultimately force them to cut interest rates even more drastically in the future. The bonds that we have been purchasing should do very well for clients.

Here's a chart of the 10 year US Treasury bond.

You can see by the chart that our original purchases enjoyed considerable success until a year ago when interest rates reversed back to the upside. It's helpful to remember that when interest rates rise, bond prices fall and when interest rates fall, bond prices rise. As much as I didn't like having the trade reversed against us, the good news is that it affords us the gift of time – time to accumulate a bigger position in this valuable security.

As the economy continues to weaken, the inherent value of this security will rise. Intervention may continue to favor junk bonds and lower quality stocks for the moment but when the weakness in our economy becomes more obvious, I believe that a lot of money will flow into the 10 year

Treasury bond very quickly as a flight to safety.

Keep in mind that we actually have states such as Illinois facing potential bankruptcy. Other states are considered vulnerable as well. If/when things start to go awry, bond investors are likely to pay a premium for the protection of the world's safest bonds and we'll be happy to sell our position to them at a nice profit.

Timing

The $64,000 question is when will the markets start to resemble reality? Nobody knows the answer to this question. Not the government, not the people who are carrying out the interventions in the markets, and not a single private investor. Nobody.

There are no chart patterns that will give us a definitive answer. No fundamental data or Black Swan events will likely bring an end to this unnatural market. It will happen when the interventionists lose control.

There are some arcane variables that we are watching for signs that the conditions for maintaining control have changed but our best defense is our investment decisions. We are careful about the investments we are making on our client's behalf. In effect, we are making investments with a clear understanding of the economy and the long term sustainability of the products each company sells.

The GeoVest Approach

I remain optimistic about the future. We live in a dynamic country where progress is never halted for long. We may have differences with our neighbors but ultimately, those differences are set aside when we collectively face struggles.

There is no denying that we're living in some very strange times but things always get strange at the end of long term cycles. Any history buff will tell you the same; our past is replete with stories of calamity and fortune, insanity and great virtue.

As much as these periods cause fear and confusion, they also bring great opportunity for those who prepare in advance. I believe we have a strong understanding of the present economic realities combined with a realistic sense of why the markets are behaving as they are.

Thank you for investing with GeoVest Advisors, it is our continued pleasure to serve you.

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